

Part B. Excluded Sources of Income--Wage Replacement Payments

REPEAL EXCLUSION FOR UNEMPLOYMENT AND DISABILITY PAYMENTS

General Explanation

Chapter 3.14

Current Law

In general, any cash wage or salary compensation received by an employee is fully includible in the employee's income. Under current law, however, payments under a variety of programs designed to replace wages lost due to unemployment or disability are fully or partially exempt from tax.

Unemployment Compensation. If the sum of a taxpayer's adjusted gross income (determined without regard to certain Social Security and railroad retirement benefits and the deduction for two-earner married couples) and his unemployment compensation is less than a "base amount" (\$12,000 for single returns and \$18,000 for joint returns), unemployment compensation will be totally excluded from gross income. If such sum exceeds the base amount, then the taxpayer's gross income will include the lesser of (i) one-half of such excess, or (ii) all of the taxpayer's unemployment compensation.

Thus, for example, if a married couple filing a joint return receives \$8,000 in unemployment compensation and has no other income, the unemployment compensation will be totally excluded from gross income. On the other hand, if the couple has \$18,000 of other income, one-half of the unemployment compensation will be included in their gross income. As income other than unemployment compensation increases, a greater percentage of unemployment compensation will be included (up to 100 percent if their other income equals or exceeds \$26,000).

Disability Compensation. Workers' compensation payments as well as black lung benefits to disabled coal miners are fully excluded from income. In addition, under statutory provisions outside the tax code, all benefits provided under laws administered by the Veterans' Administration are exempt from tax.

Net Replacement Rates. Most wage replacement programs pay benefits equal to a flat percentage of gross earnings, subject to minimum and maximum dollar limits. Although this percentage is generally stated as a gross replacement rate, the effect of a wage replacement program can be determined only by analyzing its "net replacement rates" -- the fraction of a worker's lost after-tax wages that the program replaces. Exclusion of wage replacement payments from income causes a program's net replacement rate to exceed its gross replacement rate. Assume, for example, that Individual A would

have earned \$25,000 last year and would have paid taxes of \$5,000, leaving after-tax income of \$20,000. If A is disabled and receives one-half of his gross earnings (\$12,500) in tax-free wage replacement payments, the 50 percent gross replacement rate results in a 62.5 percent net replacement rate, since \$12,500 is 62.5 percent of \$20,000.

Reasons for Change

Fairness. The fairness of a wage replacement system must be examined in terms of net rather than gross wage replacement rates, since it is the net replacement rate that indicates what percentage of the individual's true loss in wage income has been restored. The current exclusion of wage replacement benefits from income typically causes net replacement rates to exceed gross replacement rates. Moreover, this excess increases with the tax rate of the recipient's family.

Assume, for example, that individuals A and B have identical jobs and that each earns \$160 per week. Due to disability or unemployment, both suffer a loss of all wages, and each receives a payment of \$80 per week. Although each has a gross replacement rate of 50 percent, their net replacement rates may differ greatly. If A has several dependents and no other source of income, he would have paid no income tax on his \$160 per week; thus his net replacement rate equals his gross replacement rate of 50 percent. On the other hand, if B's spouse has substantial earnings so that the family is in the 30 percent tax bracket, B's net replacement rate will exceed 70 percent because his \$80 tax-free payment has replaced after-tax income of \$112.

As illustrated by a comparison of net replacement rates, the exclusion of wage replacement payments from income under current law provides the greatest benefit to single taxpayers with no dependents and to taxpayers with other sources of income. Correspondingly, current law provides the least benefit to taxpayers with several dependents and no other source of income. Moreover, the exclusion generally results in higher net replacement rates for those unemployed or disabled for short periods than for those suffering from long-term unemployment or disability.

The current disparity in net replacement rates could be redressed by redesigning wage replacement programs to take total family income into account. This solution, however, would add greatly to administrative complexity. A more efficient approach would be to tax wage replacement payments, recognizing that payment schedules could also be adjusted to maintain average net replacement rates. This would ensure comparable net replacement rates for individuals receiving benefits under the same programs.

Work Incentives. Any wage replacement program will reduce work incentives by reducing the net gain from returning to work. This effect is greatest when such payments are nontaxable, since net wage

replacement rates then increase with family income. For example, if a 66 percent net replacement rate is desired for low-income families, it will be necessary to provide a 66 percent gross replacement rate for low-wage workers. Unless benefit payments are based on need, however, a 66 percent gross replacement rate may result in net replacement rates in excess of 100 percent for low-wage workers from high-income families.

Such high replacement rates are clearly undesirable. However, as long as payments are nontaxable and are not based on need, any increase in the net replacement rates for low-income families will create extremely high net replacement rates for low-wage workers from wealthier families. With respect to unemployment compensation, taxing an increasing percentage of unemployment compensation as the recipient's income increases above his "base amount" creates peculiar work disincentives. For example, if a married individual receives \$5,000 in unemployment compensation, each additional dollar that the individual or his or her spouse earns between \$13,000 and \$23,000 will require inclusion in their gross income of another \$0.50 of the unemployment compensation. In effect, each additional dollar of earned income within that range increases their taxable income by \$1.50, and thereby multiplies their marginal tax rate by 1.5 for each dollar of earned income within that range. Such perverse results are inevitable if such a threshold is used.

The conflict between minimum replacement rates and work incentives is greatly reduced if benefits are taxed, even if the average net replacement rate is maintained through higher payments.

Neutrality. Wage replacement payments are presumably reduced in recognition that they are nontaxable, thereby reducing the cost of funding such programs. If the programs are paid for by employers (either through insurance or taxes), exclusion provides an indirect subsidy to industries with high injury or layoff rates, and indirectly raises tax rates on other income. Since the costs of job-related injuries and anticipated layoffs is a real cost of production, this subsidy distorts market prices and resource allocation. Although neutrality could also be achieved by treating wage replacement programs as insurance and taxing employees on the "premiums" paid by employers, this would be administratively difficult and would do nothing to reduce the problems of fairness or work disincentives discussed above.

The exclusion from taxation may also hide the true cost of government-mandated programs from the policymakers who determine their scope and size. Taxing wage replacement payments would enable policymakers to make more informed decisions.

Proposal

All unemployment compensation would be included in income.

In addition, all cash payments for disability from workers' compensation, black lung, and veterans' programs would be included in income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, burial fees, and non-service related veterans' disability payments.

The Treasury Department proposals include an expanded credit for the elderly, blind, and disabled. See Chapter 2.02. In order to protect low- and moderate-income disabled taxpayers, the proposal would make all taxable disability payments (up to \$6,000 for individual returns and \$9,000 for joint returns) eligible for a 15 percent tax credit. The amount eligible for the credit would be reduced by any Title II social security benefits and by one-half of the excess of adjusted gross income over \$7,500 (\$10,000 for joint returns).

Effective Dates

The proposal would apply to all unemployment compensation received on or after January 1, 1987.

With respect to workers' compensation payments, the proposal would apply to all payments received by employees or their survivors for disabilities occurring on or after January 1, 1987. Payments received for a disability occurring before such date would remain nontaxable.

The proposal would apply to all black lung and veterans' service-related disability payments received on or after January 1, 1987, regardless of the date on which the disability occurred.

Analysis

In General. Taxing wage replacement payments would eliminate the disparities in net replacement rates under current law. It would thus be possible to replace 50 percent of lost wages for workers in low-income families without providing net replacement rates far above that rate for workers from families with substantial income from other sources. This would enable wage replacement programs to target the benefits to those who need them most.

Unemployment Compensation. Most unemployment compensation is now excluded from gross income. In 1982, only one-third of such payments was taxed. Of \$20.6 billion in payments, only \$7 billion were included in gross income. Over \$3.8 billion was received by taxpayers with adjusted gross incomes between \$18,000 and \$30,000, more than 30 percent of which was excluded from gross income.

Most unemployment compensation is received by families with other sources of income. In addition, most unemployed individuals remain unemployed for less than 15 weeks, so their unemployment compensation supplements income from employment during the rest of the year. Under such circumstances, the exclusion of unemployment compensation from income provides an unnecessary and unfair tax advantage. For example, a married person earning \$15,000 during the year and receiving \$3,000 in unemployment compensation now pays substantially less tax than someone working all year and earning \$18,000.

Any unemployment compensation program will necessarily create some work disincentives. The proposal, however, would eliminate the peculiar disincentives created by the threshold for taxing such benefits under the current system.

States may wish to adjust their unemployment compensation programs if all such compensation is included in gross income. A State that pays benefits equal to 50 percent of gross wages will provide net replacement rates of less than 50 percent to most unemployed workers. The Treasury Department proposals include increased personal exemptions and zero bracket amounts, along with lower tax rates. As a consequence, most workers who are unemployed for a long time and have little access to other sources of income would pay little or no tax on their benefits. The proposed effective date would provide time, however, for States to adjust benefits to protect even more workers.

Disability Payments. By combining all special treatment for the disabled in a single tax credit, the proposal would ensure that preferential treatment for the disabled is provided in a fair and consistent manner. Persons receiving workers' compensation, black lung, and service-related veterans' disability payments would be treated similarly to persons who are disabled and receive disability pay from an employer. In both cases, the tax-exempt level of income for a single person who is disabled for the entire year and depends mostly on such disability payments would be \$9,700. For a family of four, the tax-exempt level would be \$17,200. These tax-exempt levels are substantially in excess of the tax-exempt levels applicable to other taxpayers (\$4,800 for single returns; \$11,800 for families of four). In approximately 80 percent of the States, a family of four solely dependent on workers' compensation would pay no Federal income tax even if it received the maximum payment under that State's program.

Table 1

Distribution of Workers' Compensation Payouts

Family Economic Income	Percentage of All Families	Percentage of Cash Payments From Workers' Compensation
\$ 0 - 10,000	15.0	4.1
10,000 - 15,000	12.7	7.4
15,000 - 20,000	11.7	8.3
20,000 - 30,000	19.3	22.2
30,000 - 50,000	23.3	33.7
50,000 - 100,000	15.4	22.4
100,000 - 200,000	2.1	1.3
200,000 and above	0.5	0.4
	100.0	100.0

Office of the Secretary of The Treasury
Office of Tax Analysis

November 30, 1984

As illustrated in Table 1, workers' compensation benefits are received primarily by middle- and upper-income taxpayers. This is largely attributable to the fact that most of those receiving workers' compensation are off work for less than three weeks (with less than one percent permanently and totally disabled), and benefits are related to wage levels. Since each dollar of excluded income is worth more to those in higher tax brackets, the tax benefits from current law are concentrated among higher income families. The higher tax-free threshold would ensure that no families below the poverty line are taxed on income from any source.

Despite the extensive protection the proposal provides for the low- and moderate-income disabled, the taxation of these forms of disability income generates substantial revenue which can be used to reduce tax rates on other income.

The repeal of the exclusion is delayed until 1987 to allow the State and the Federal governments to make any desired compensatory changes in their benefit schedules. Moreover, in the case of workers' compensation, the repeal would apply only to those receiving workers' compensation for disabilities occurring on or after January 1, 1987. Since most workers' compensation payments are made by private insurance companies, payments for past injuries are funded from premiums paid in the past. As a result, there is no easy way to adjust such payments for the change in tax status. No such grandfathering is proposed for the two Federal programs (black lung and veterans' service-related disability) because those payments can be adjusted, if desired, for all beneficiaries.

The exception for non-service-related disability payments is justified by the nature of that program, which is most accurately categorized as a welfare program. Benefits are small and strictly based on any other source. Such means-tested payments are generally excluded from gross income. Moreover, the criteria for such payments would ensure that no recipient of these veterans' benefits would pay income tax even if such benefits were made fully taxable.